



# IMPACT OF DEMONETISATION ON BANKS

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## ABSTRACT

The demonetisation move by the Government of India created multifaceted waves in the country. All the sectors of the economy had faced mixed emotions as a result of this move. One sector of the economy which was affected to a great extent is banking industry. Banks were the channels through which demonetisation was carried out because 86% of the currency in circulation was withdrawn and non-cash transactions were promoted through banks and other allied e-payment activities. Such attempts of demonetisation were made earlier also by the government but not to this extent and volume. Positively, the liquidity position of the banks was increased due to the enhanced deposit base which was resulted by the deposit of old currency notes in the banks. At the same time, though the Government and Reserve Bank of India took necessary steps to curb the negative impacts of demonetisation, it resulted in accumulation of stressed assets, reduction in the demand for credit and reduction in profitability. Since the economic growth of the country to a great extent is directly related with the efficient functioning of banks, the demonetisation move has at least slowed down the pace of the economic growth and progress of the country.

**KEY WORDS:** Demonetisation, Stressed Assets, NPA, MSME.

## Introduction

On 8<sup>th</sup> November Government of India announced that Rs. 500 and Rs.1000 ceases to be a legal tender. These high value currencies constituted 86% of the total cash in circulation. The reasons pointed out for such a movement were

- 1) To eradicate the black money in the form of currency that will eradicate the parallel economy (the black economy today is 62 percent of GDP i.e. Rupees 93 lakh crore),
- 2) To control the flow of counterfeit currency in the country which promotes terrorist activities in Jammu and Kashmir and other Naxal-infested states and
- 3) To promote a cashless economy.

Various sectors of the economy had divergent effects due to demonetisation and banking sector was one of the prominent one to affect adversely. Demonetisation not only reduced the lending business especially in the agriculture and MSME (Micro, Small, Medium) sector but also affected the recovery of the bad loans. In addition to that more accounts which were performing are turning to non-performing due to the cash crunch.

## History of demonetisation in India

In India, prior to November 8, two times currency has withdrawn. The first withdrawal was in January 1946. The currency in circulation of Rs. 1000, Rs. 5000 and Rs. 10000 were taken out of circulation. However, all these three denominations were brought into circulation later in 1954. The highest denomination of Rs. 10000 was printed by Reserve Bank of India in 1938.

In 1970 there was an attempt to demonetise the high value notes in order to unearth and prevent black money and its circulation. The suggestion came from Wanchoo Committee set up by the Government. However, the public nature of recommendations made the black money holders to act promptly and get rid of the black money even before Government intervened in the situation.

The second demonetisation took place in 1978 by introducing The High Denomination Bank Notes (Demonetisation) Act, which declared rupees 1000, Rs. 5000 and Rs. 10000 as illegal. It was introduced even though the then RBI Governor gave a dissenting note.

## Impact of demonetisation

There are multifarious effects on various sectors of the economy due to demonetisation. It will give a big blow to the real estate business and only those entities with strong balance sheet will survive the worse conditions. The stock market also will have an adverse impact because cash turns to be a scarce item and thereby impacting the Indian corporations' revenues. Indian rupee also gets weaker as foreign investors will pull out of from Indian shores. Pressure is also created in the advertising and media sector due to the postponement and cancellations of campaigns. Indian Rural economy also will be severely affected as most of the rural economy to a great extent depends upon cash economy. Both retail and wholesale trade is seriously affected as they primarily deal in cash

which made them to stop trading. The impact of demonetisation in banking industry is also significant, with mixed feelings. The following are the impact of demonetisation on banks.

## A-Diminishing Asset quality

The greatest problem that banks face due to demonetisation is that it affects the quality of assets of the banks in the form of loans given to different sectors. The loss of income by small borrowers has considerably affected the repayment of loans. In addition to that those employees placed on recovery activities had to be called back due to the sudden requirement of managing the work in the branches of the bank due to demonetisation. Companies are also affected by the rising working capital cycle which needs to support the supply chain which often needs cash. Small and Medium sized businesses are highly cash-dependent businesses which will in turn increase the platform of stressed loans. Top bankers just recovered Rs. 7909 crores in the quarter ended December 2016 as against Rs. 10177 crores for the quarter ended September 2016. The following table gives a clear picture of diminishing asset quality. Gross Non Performing Assets (NPA) means the advances which are irrecoverable for which provisions are made and which are appearing in the books of accounts. Net Non Performing Assets are arrived at after deducting the following items from the Gross NPA namely, balance in the interest suspense account, claims received from credit guarantors, part payments received and total provisions held. The below mentioned percentages are towards the total advances given by the banks. A comparative analysis makes it clear that there is increase in both Gross NPA and Net NPA.

Name of Banks	Gross NPA		Net NPA	
	September 2016	December 2016	September 2016	December 2016
State Bank of India	7.14 %	7.23%	4.19%	4.24%
Allahabad Bank	12.28%	12.51%	8.59%	8.65%
Canara Bank	9.81%	9.97%	6.69%	6.72%
Indian Bank	7.28%	7.69%	4.62%	4.76%
Central Bank of India	13.70%	14.14%	8.17%	8.54%
Union Bank of India	10.73%	11.70%	6.39%	6.95%
Corporation Bank	10.81%	11.26%	6.91%	7.64%
Dena Bank	13.79%	14.79%	8.93%	9.52%
Dhanalakshmi Bank	6.86%	7.59%	2.52%	2.90%
The Catholic Syrian Bank	5.70%	8.80%	4.14%	6.18%
Punjab National Bank	13.63%	13.70%	9.10%	9.09%
Syndicate Bank	7.72%	8.69%	5.03%	5.63%
UCO Bank	16.51%	17.18%	8.83%	8.99%

Source: Respective website of banks

**B-Reduction in the demand for credit**

Another important impact of demonetisation is reduction in the demand for credit in the Mid Corporate Advances and MSME (Micro, Small and Medium Enterprise) Advances. The agriculture sector also responded adversely as far as availing credit from the banks. These sectors to a great extent work on cash economy which reduced the pace of availing credit from the banks. The total slow down in the economic growth will reduce the use of borrowed fund. Earlier it is expected that the growth of advances in the banking sector to be 10-11 percent. However, after demonetisation it is presumed to be 5-6 percent. There was tremendous credit off take during the nine month period time from April 2016 to December 2016 which stood at Rs. 89500 crores only. It was Rs. 403220 crores in the similar time period during 2015.

(Rupees in Crores)

Name of Banks	MSME		Agriculture	
	September 2016	December 2016	September 2016	December 2016
Indian Bank	19869	19373	24677	24308
Allahabad Bank	29646	28879	26997	26875
Canara Bank	70120	70442	72705	71457
Union Bank of India	58268	57097	41159	40723
Central Bank of India	33406	32338	40616	38129
Dena Bank	13145	12441	12511	12381
Oriental Bank of Commerce	23540	22558	24417	23950
Syndicate Bank	27512	26456	28186	29734
United Bank of India	10392	10191	11691	11277
Vijaya Bank	19076	16631	14804	15041

*Source: Respective website of banks***C-Enhanced deposit base**

A substantial portion of high value notes are coming back to the banks and it will increase the deposit base. As a result the cost of funds will be coming down which will result in reducing the rate of interest. This will lead to the demand of government securities and other high rated bonds in the environment. Though current and savings account gave an enhanced result as far as deposit base is considered, fixed deposit base become narrow in some cases.

(Rupees in Crores)

Name of Banks	September 2016 (Deposit)			December 2016 (Deposit)		
	Current	Savings	Term	Current	Savings	Term
Dena Bank	6079	28976	70040	7712	37988	73518
Syndicate Bank	10494	53262	-	11437	66285	-
United Bank of India	7824	43445	66623	9698	51273	66721
Indian Bank	6497	47301	114318	7288	53895	108061
Allahabad Bank	9359	67048	119597	12111	79322	116036
Vijaya Bank	5933	23020	84888	8085	28731	84751
Canara Bank	20663	111075	352583	21618	132087	356622
Union Bank of India	23460	90551	-	29592	110116	-

*Source: Respective website of banks***D-Reduction in profitability**

One of the elements that affect the profitability of banks is the provisions to be made for Non Performing Assets. As the asset quality come down automatically banks have to provide for more provisions in order to meet with the provisioning requirements. This will in turn reduce the net profit of the banks. There has been considerable fall in the disbursement of loans in the agriculture and MSME sector. This will result in fall of interest accrued or received which will in turn reduce the profits of the banks. Another reason for the reduced profit is the enhanced deposit base due to which banks will be incurring additional expenses in the nature of interest. The following table sheds sufficient light on how the profitability of the banks is affected.

Name of the banks	NPA Provision		Interest Received(Advance)		Interest Paid(Deposit)	
	Sept 2016	Dec 2016	Sept 2016	Dec 2016	Sept 2016	Dec 2016
Allahabad Bank	6224	6393	3303	3060	2919	2961
Dena Bank	554	426	1854	1738	1787	1795
Indian Bank	601	647	3994	3957	2716	2710
Oriental Bank of Commerce	687	1429	3356	3031	3209	3153
Punjab National Bank	2218	3363	8467	8263	7950	8253
UCO Bank	980	914	2656	2572	3083	3217

*Source: Respective website of banks***Efforts taken by Government to neutralize the impact of demonetization**

The move of demonetization was to crack down the shadow economy, but resulted in virtual standstill of cash economy. A number of measures were taken by Government of India and Reserve Bank of India to ease the pain caused by demonetization. The following are some of such efforts:

- Withdrawal of temporary order to place cash under cash reserve ratio
- Raising of the limits for market stabilization bonds in order to absorb extra liquidity.
- Introduction of tax amnesty scheme for unreported cash which attracts 50% tax and surcharge
- Allowing Rs. 210 billion in the form of farm credit to the farmers
- Direction to the central government departments and public sector undertakings to shift to the e-payment system
- Waiving of transaction charges on transactions settled through National Financial Switch (NFS)
- Efforts to recalibrate the ATMs to dispense the new currency notes.

**Conclusion**

The efforts taken by government through demonetization will definitely bring sufficient funds into the hands of banks which will in turn place the banks in a better position as far as liquidity is concerned. It is very clear and evident from the enhanced deposit base. It will also give banks an opportunity to utilize these funds and earn more revenue. But the question remains whether the efforts made to curb the shadow money will be fulfilled? Further it has adversely affected the banking system as it has increased the quantum of stressed assets. Stressed assets result in non-repayment of both principal and interest. Though the liquidity element will not be affected much due to large deposit base, the non-payment of interest will definitely result in poor financial performance of the banks. The stressed assets will also lead into adverse performance situations because banks need to provide provisions according to the prudential norms, which have got a direct impact on its profitability. The image and goodwill of the banks will be at stake. Stressed assets also have another evil effect that banks will be reluctant to disburse loans especially to the priority sectors. Once the catering of funds in the priority sector is disturbed there will be serious consequences in the production and other related activities. The result will be social unrest, unemployment, poor and stagnant economic growth and prosperity.

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